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IN THE

Supreme Court of the United States

STONERIDGE INVESTMENT PARTNERS, LLC,

Petitioner,

v.

SCIENTIFIC-ATLANTA, INC. and MOTOROLA, INC.,

Respondents.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

BRIEF OF THE NEW YORK STATE TEACHERS' RETIREMENT SYSTEM, THE RETIREMENT SYSTEMS OF ALABAMA, THE SACRAMENTO COUNTY EMPLOYEES' RETIREMENT SYSTEM, AND THE GOVERNMENT OF GUAM RETIREMENT FUND AS *AMICI CURIAE* IN SUPPORT OF PETITIONER

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INTEREST OF AMICI CURIAE[1]

This brief is filed by public pension systems who purchase publicly traded securities on behalf of their beneficiaries and, therefore, have a strong interest in the proper interpretation of the securities laws. These investors believe that Section 10(b) of the Securities Exchange Act of 1934 ("Exchange Act") and Securities and Exchange Commission ("SEC") Rule 10b-5 should be interpreted in accordance with their plain language and to achieve Congress's intent to permit investors to recoup their losses caused by deceptive conduct in connection with purchases and sales of securities from the perpetrators of the deceptive conduct, deter future frauds, and maintain fair, honest, and efficient capital markets.

Each year, *amici* invest billions of dollars in U.S. capital markets on behalf of hundreds of thousands of beneficiaries. The New York State Teachers' Retirement System ("NYSTRS") has over $100 billion in assets as of March 31, 2007, of which over $67 billion is invested in domestic fixed income and equity securities. NYSTRS is one of the ten largest public retirement systems in the United States and provides retirement benefits for approximately 264,000 active and 130,000 retired New York State public school teachers and administrators. The Retirement Systems of Alabama ("RSA") manages 20 funds with aggregate assets of over $30 billion as of September 30, 2006 for the benefit

1. This brief was not authored, in whole or in part, by counsel for either party, and no person or entity other than *amici* and their counsel contributed monetarily to the preparation or submission of the brief. The parties have consented to the filing of this brief, and copies of their consents are being filed herewith.

of approximately 213,000 active and 95,000 retired public school teachers, State judges, and other employees of the State of Alabama. Approximately 48% of RSA's assets is invested in domestic common and preferred stocks, and approximately 20% in domestic bonds. The Sacramento County Employees' Retirement System ("SCERS") has $5.8 billion in assets as of March 31, 2007, of which over $2.0 billion is invested in domestic equity securities and $1.3 billion in fixed income securities. SCERS provides retirement benefits for more than 14,000 active and 5,000 retired employees of Sacramento County, California. The Government of Guam Retirement Fund is a $3.94 billion pension plan for employees of the Government of Guam.

In the aggregate, state and local government pension plans such as these cover more than 14 million workers and 6 million retirees and other beneficiaries and have assets of more than $2 trillion.[2] In 2005, investment earnings accounted for 74 percent of all public pension plan revenue and employer (*i.e.*, taxpayer) contributions for only 17 percent.[3]

The *amici*'s overriding responsibility is to invest for the retirement and long-term security of their hundreds of thousands of beneficiaries. As major investors with long-term outlooks, the *amici* are vitally concerned with the proper and efficient functioning of U.S. capital markets, and are particularly concerned that investors not be harmed by illegal

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2. *See* Gary W. Anderson & Keith Brainard, "Profitable Prudence: The Case for Public Employer Defined Benefit Pension Plans," Pension Research Council Working Paper 2004-6, The Wharton School, University of Pennsylvania, *available at www.nasra.org/resources/dbdcissues.htm* (last visited on June 1, 2007).

3. *See* National Association of State Retirement Administrators, "Key Facts Regarding State and Local Government Defined Benefit Retirement Plans," *available at* www.nasra.org/news/article.asp?newsid=112 (last visited on June 1, 2007).

conduct affecting the market for publicly traded securities. Many state and local governments are constitutionally obligated to guarantee defined benefit retirement plans. Therefore, investment losses due to securities fraud fall directly on state and local governments and ultimately on taxpayers. If public pension funds are prevented from recovering money lost to securities fraud, the public will suffer.

The recent scandals at companies such as Enron, WorldCom, Global Crossing, Tyco, and McKesson-HBOC have unfortunately shown that even large, well-known companies and their business partners are not immune to the development of a culture of greed which encourages short-sighted and ultimately wrongful business practices and eventually results in billions, if not trillions of dollars in losses to innocent investors. As investors who have been materially harmed by corporate fraud, *amici* are vitally concerned that the law allow injured investors to recover from perpetrators of fraud.

The *amici* strongly believe that investors' ability to redress corporate wrongdoing through class and individual actions under the securities laws is essential to deter improper conduct and to recoup losses caused by fraud. Indeed, in passing the Private Securities Litigation Reform Act of 1995, Pub. L. No. 104-67 ("PSLRA"), Congress sought "to increase the likelihood that institutional investors will serve as lead plaintiffs," based on its belief "that increasing the role of institutional investors in class actions will ultimately benefit shareholders and assist courts by improving the quality of representation in securities class actions." H.R. Conf. Rep. 104-369, 1995 U.S.C.C.A.N. 730, 732.[4] Following the

4. The *amici*, as long-term investors, also have a strong interest in preventing meritless, lawyer-driven litigation. As one of many ways the PSLRA discourages meritless cases, the statute's (Cont'd)

passage of the PSLRA, the *amici* have served as lead plaintiffs in cases resulting in substantial recoveries, including *In re HealthSouth Corp. Bondholder Litigation*, No. 03-CV-1500 (N.D. Ala.), in which Retirement Systems of Alabama is the court-appointed lead plaintiff and has achieved partial settlements totaling approximately $445 million from HealthSouth and other defendants. Retirement Systems of Alabama is continuing to prosecute claims against certain defendants, including "scheme liability" claims under Rule 10b-5(a) and (c) against HealthSouth's auditor and underwriters for their allegedly knowing, deceptive conduct in furtherance of the scheme to defraud HealthSouth investors.

SUMMARY OF ARGUMENT

When a defendant knowingly engages in conduct that has the principal purpose and effect of creating a false appearance of fact about a public corporation's business and financial results in furtherance of a scheme to defraud the corporation's investors, the defendant's acts fall squarely within the express scope of Section 10(b) of the Exchange Act and Rule 10b-5(a) and (c). *See Simpson v. AOL Time Warner, Inc.*, 452 F.3d 1040, 1048 (9th Cir. 2006), *petition for certiorari filed sub nom. Avis Budget Group, Inc. v.*

(Cont'd)

"professional plaintiff" provision bars a plaintiff from serving as lead plaintiff in more than five actions filed within three years, except as permitted by the court. *See* 15 U.S.C. § 78u-4(a)(3)(B)(vi). Notably, Congress gave courts discretion to allow "[i]nstitutional investors seeking to serve as lead plaintiff. . . to exceed this limitation [because they] do not represent the type of professional plaintiff this legislation seeks to restrict." H.R. Conf. Rep. 104-369, 1995 U.S.C.C.A.N. 730, 734.

California State Teachers' Retirement System, No. 06-560 (U.S. Oct. 19, 2006). Regardless of whether such a defendant made a public statement concerning the deceptive transaction, the defendant has engaged in deceptive conduct constituting a primary violation of Section 10(b), which makes it unlawful for "any person, directly or indirectly, . . . [t]o use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance in contravention of [Rule 10b-5]." 15 U.S.C. § 78j(b). Rule 10b-5, which is coextensive with Section 10(b), imposes primary liability on persons who "directly or indirectly . . . employ any device, scheme or artifice to defraud" or "engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of a security." 17 C.F.R. § 240.10b-5(a) and (c). To find otherwise – to immunize parties who enter into sham transactions that have the principal purpose and effect of artificially distorting a public company's financial statements – would be to rewrite and unduly narrow both the statute and rule.

This Court's precedents, including *Central Bank, N.A. v. First Interstate Bank, N.A.*, 511 U.S. 164 (1994), support liability for such persons. *Central Bank* states that "any person or entity, including a lawyer, accountant, or bank, who employs a manipulative device or makes a material misstatement (or omission) on which a purchaser or seller of securities relies may be liable as a primary violator under 10b-5, assuming *all* of the requirements for primary liability under Rule 10b-5 are met." 511 U.S. at 191 (emphasis in original). *Central Bank*'s holding "that a private plaintiff may not maintain an aiding and abetting suit under § 10(b)" did not eliminate primary liability for violations of Rule 10b-5(a) and (c) and could not do so without ignoring the plain

language of the statute and reading subsections (a) and (c) out of the rule. Post-*Central Bank* decisions of this Court confirm that, in addition to making a material misstatement, using a manipulative or deceptive device can give rise to liability under Section 10(b) and Rule 10b-5. *See, e.g.*, *SEC v. Zandford*, 535 U.S. 813, 815 (2002) ("Indeed, each time respondent 'exercised his power of disposition [of his customers' securities] for his own benefit,' that conduct, without more, was a fraud.").

Construing Section 10(b) and Rule 10b-5 in accordance with their plain language does not threaten to impose liability for securities fraud on those who participate in legitimate commercial transactions with public corporations. A legitimate transaction becomes neither a "device, scheme or artifice to defraud" under Rule 10b-5(a) nor an "act, practice, or course of business which operates or would operate as a fraud or deceit" under Rule 10b-5(c) simply because a public corporation involved in the transaction chooses to misrepresent that transaction in its financial statements. A commercial counterparty is subject to scheme liability under Rule 10b-5(a) and (c) only if the commercial counterparty itself engages in deceptive conduct – *i.e.*, if the principal purpose and effect of the counterparty's own conduct is to artificially distort the public corporation's financial statements or otherwise create a false appearance about its business. A commercial counterparty that enters into an inherently legitimate loan or other transaction with a securities issuer does not engage in deceptive conduct, even if the counterparty knows that the issuer plans to make false statements about the transaction, so long as the principal purpose and effect of the counterparty's action is not to distort the public company's financial statements. In that circumstance, the counterparty is at most an aider and abettor

and, as such, is not subject to liability for securities fraud. *See Simpson v. AOL Time Warner Inc.*, 452 F.3d at 1050.

The stringent pleading standards for allegations of fraud under Rule 10b-5 further protect legitimate commercial counterparties. In particular, plaintiffs must adequately allege that the commercial counterparty acted with scienter under the demanding pleading standard of the PSLRA.

ARGUMENT

I. THE PLAIN LANGUAGE OF SECTION 10(b) AND RULE 10b-5 IMPOSES LIABILITY ON PERSONS WHO ENGAGE IN MANIPULATIVE OR DECEPTIVE DEVICES OR ACTS

"With respect . . . to the first issue, the scope of conduct prohibited by § 10(b), the text of the statute controls [the Court's] decision." *Central Bank*, 511 U.S. at 173. This Court's "cases considering the scope of conduct prohibited by § 10(b) in private suits have emphasized adherence to the statutory language, '[t]he starting point in every case involving construction of a statute.'" *Id.* (quoting *Ernst & Ernst v. Hochfelder*, 425 U.S. 185, 197 (1976); alteration in *Central Bank*). Section 10(b) of the Exchange Act explicitly delegates authority to the SEC to prescribe rules, "as necessary or appropriate in the public interest or for the protection of investors," making it "unlawful for any person, directly or indirectly," to "use or employ, in connection with the purchase or sale of any security . . . any manipulative or deceptive device or contrivance." 15 U.S.C. § 78j(b). The SEC has implemented Section 10(b) by adopting Rule 10b-5, which is "coextensive with the coverage of § 10(b)." *SEC v. Zandford*, 535 U.S. at 816 n.1 (citing *United States v. O'Hagan*, 521 U.S. 642, 651 (1997), and *Ernst & Ernst v.*

Hochfelder, 425 U.S. at 214); *see also Central Bank*, 511 U.S. at 172 ("Rule 10b-5 . . . casts the prohibition in similar terms" to Section 10(b)).

Rule 10b-5(a) makes it unlawful for "any person," "directly or indirectly," to "employ any device, scheme, or artifice to defraud." This Court has held that "any manipulative or deceptive device or contrivance" in Section 10(b) includes a "project," "scheme" (including "a scheme to deceive"), "stratagem," "artifice," and "plan," *Ernst & Ernst v. Hochfelder*, 425 U.S. at 199 n.20 (citing definitions of "device" and "contrivance" from WEBSTER'S INTERNATIONAL DICTIONARY (2d ed. 1934)), and that Section 10(b) applies to "complex securities frauds" in which "there are likely to be multiple violators," *Central Bank*, 511 U.S. at 191. Rule 10b-5(c) makes it unlawful for "any person," "directly or indirectly," to "engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. . . ."

The prohibitions of Section 10(b) and Rule 10b-5(a) and (c) apply to conduct beyond the making of false statements and misleading omissions, which are prohibited by Rule 10b-5(b). As this Court has held, Section 10(b) also applies to deceptive "practices," *Santa Fe Indus., Inc. v. Green*, 430 U.S. 462, 475-76 (1977), deceptive "conduct," *id.* at 475 n.15; *O'Hagan*, 521 U.S. at 659, and deceptive "acts," *Central Bank*, 511 U.S. at 173. "To be sure, the second subparagraph of the rule [i.e., Rule 10b-5(b)] specifies the making of an untrue statement of a material fact and the omission to state a material fact. The first and third subparagraphs [i.e., Rule 10b-5(a) and (c)] are not so restricted." *Affiliated Ute Citizens v. United States*, 406 U.S. 128, 152-53 (1972). Indeed, Rule 10b-5 forbids "any course

of conduct that has the effect of defrauding investors." *Ernst & Ernst v. Hochfelder*, 425 U.S. at 212. Section 10(b) and Rule10b-5's "proscriptions, by statute and rule, are broad and, by repeated use of the word 'any,' are obviously meant to be inclusive." *Affiliated Ute Citizens*, 406 U.S. at 151.

Were the Court to hold that a person who engages directly or indirectly in conduct which has the primary purpose and effect of creating a false appearance about an issuer's business and financial results is not a primary violator of Section 10(b) and Rule 10b-5, the Court would effectively be eliminating the express language "directly or indirectly . . . to use or employ . . . any manipulative or deceptive device or contrivance" from the statute, as well as reading subsections (a) and (c) out of the rule. As the Court has often held, a statute should not be construed in a way that renders some of its provisions superfluous. *See, e.g., TRW Inc. v. Andrews*, 534 U.S. 19, 31 (2001); *Ratzlaf v. United States*, 510 U.S. 135, 141 (1994).

Zandford demonstrates that Rule 10b-5(a) and (c) are indeed not superfluous. In that case, the Court held that a broker's course of conduct in selling his customers' securities in order to misappropriate the proceeds, without making any misrepresentations actionable under Rule 10b-5(b), constituted a fraudulent scheme under Rule 10b-5(a) and a course of business that operated as a fraud under Rule 10b-5(c): "Indeed, each time respondent 'exercised his power of disposition [of his customers' securities] for his own benefit,' that *conduct*, '*without more*,' was a fraud." 535 U.S. at 815 (emphasis added).[5] Similarly, a party who engages in

5. Respondents may seek to distinguish *Zandford* by arguing that the broker's liability in that case depended on his omission to (Cont'd)

inherently deceptive transactions with a securities issuer – transactions whose principal purpose and effect is to create a false appearance about the issuer's business and financial results – engages in deceptive conduct that is designed to and has the effect of defrauding investors. Such inherently deceptive conduct by a "secondary" actor gives rise to primary liability under Rule 10b-5(a) and (c). It differs from aiding and abetting that does not itself involve deceptive conduct by the secondary actor, such as making a legitimate loan that the lender knows or believes the issuer intends to account for improperly as equity. By contrast, aiding and abetting a fraud by entering into a loan or other intrinsically legitimate transaction should not be actionable under any

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(Cont'd)

state material facts when he had a duty to disclose the truth to his clients. *See, e.g.*, Taavi Annus, *Scheme Liability Under § 10(b) of the Securities Exchange Act of 1934*, 72 Mo. L. Rev. No. 3 (forthcoming), *available at http://papers.ssrn.com/sol3/papers.cfm?abstract_id=980025*, at *26 ("supporters of the restrictive view [of scheme liability] . . . claim that the theory used in *Zandford* was based on a violation of a duty to disclose (i.e. omission) on the part of the broker who had fiduciary duties towards his client"). However, the Court's opinion in *Zandford* describes "conduct, 'without more,'" not "omissions," as constituting the fraud, 535 U.S. at 821, and cases finding liability for deceptive conduct in the absence of any disclosure are sometimes, like *Zandford*, based on Rule 10b-5(a) and (c), not Rule 10b-5(b), because Rule 10b-5(b) prohibits omissions only when there is a duty to correct previous statements. *See Chiarella v. United States*, 445 U.S. 222, 225 n.5 (1980); *United States v. Bongiorno*, No. 05 Cr. 390(SHS), 2006 WL 1140862, at *7-9 (S.D.N.Y. May 1, 2006). Thus, *Zandford*'s holding that conduct without more constituted fraud did not depend on whether the broker had a duty to disclose the truth to his clients. *See also In re Mutual Funds Investment Litig.*, 384 F. Supp. 2d 845, 855-62 (D. Md. 2005) (holding that brokerage firms and investment funds that created and profited from scheme to engage in late trading of mutual fund shares could be held liable under Rule 10b-5 (a) and (c)).

section of Rule 10b-5, even if the party entering into the loan or other intrinsically non-deceptive transaction knows or has reason to know that the issuer intends to make false statements about the transaction.

This Court has consistently held that Section 10(b) should be construed "'not technically and restrictively, but flexibly to effectuate its remedial purposes.'" *Zandford*, 535 U.S. at 819 (quoting *SEC v. Capital Gains Research Bureau*, 375 U.S. 180, 186 (1963)). One of Congress's principal stated purposes in enacting the Exchange Act, including Section 10(b), was "to insure the maintenance of fair and honest markets in [securities] transactions." 15 U.S.C. § 78b. Under this Court's flexible construction of their broad and inclusive terms in light of that purpose, Section 10(b) and Rule 10b-5 "prohibit all fraudulent schemes in connection with the purchase or sale of securities, whether the artifices employed involve a garden type variety of fraud, or present a unique form of deception. Novel or atypical methods should not provide immunity from the securities laws." *Superintendent of Ins. v. Bankers Life & Cas. Co.*, 404 U.S. 6, 11 n.7 (1971).

The standard advocated by *amici* in this brief is consistent with the standard adopted by the Ninth Circuit in *Simpson v. AOL Time Warner Inc.*, 452 F.3d 1040 (9th Cir. 2006), in which the court accepted the SEC's argument that "[a]ny person can be primarily liable under Section 10(b) and Rule 10b-5(a) for engaging in a scheme to defraud, so long as he himself, directly or indirectly, engages in a manipulative or deceptive act as part of the scheme." *Simpson v. Homestore.com, Inc.*, No. 04-55665, Brief of the Securities and Exchange Commission, *Amicus Curiae*, in Support of Positions That Favor Appellant, at *16 (9th Cir. Oct. 22, 2004), *available at* www.sec.gov/litigation/briefs/homestore_102104.pdf. In that case, the SEC urged the

following test for determining when a party's conduct as part of a scheme to defraud constitutes a primary violation:

> Any person who directly or indirectly engages in a manipulative or deceptive act as part of a scheme to defraud can be a primary violator of Section 10b-5 and Rule 10b-5(a); any person who provides assistance to other participants in a scheme but does not himself engage in a manipulative or deceptive act can only be an aider and abettor.

Id. (emphasis added). *See also Simpson v. Homestore.com, Inc.*, No. 04-55665, Reply Brief of the Securities and Exchange Commission, *Amicus Curiae*, in Support of Positions That Favor Appellant (9th Cir. Feb. 4, 2005), *available at* www.sec.gov/litigation/briefs/homestore_020405.pdf.[6]

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6. The *amici*, of course, advocate a "no" answer to the question presented as stated in the Court's Order granting certiorari in this case:

> Whether this Court's decision in *Central Bank* . . . *forecloses* claims for deceptive conduct under § 10(b) . . . and Rule 10b-5(a) and (c) . . . where [defendants] engaged in transactions with a public corporation with no legitimate business or economic purpose except to inflate artificially the public corporation's financial statements, but where [defendants] themselves made no public statements concerning those transactions.

Order, No. 06-43 (U.S. Mar. 26, 2007) (emphasis added). However, *amici* respectfully urge that, when answering the question presented in the negative, the Court also make clear that conduct having no legitimate business or economic purpose will not be saved from liability through the addition of some insubstantial business purpose

(Cont'd)

To establish a defendant's liability under Section 10(b) and Rule 10b-5, the plaintiff must prove not only (1) that the defendant used or employed a manipulative or deceptive device or contrivance, (2) with scienter, but also (3) a connection with the purchase or sale of a security, (4) reliance, (5) economic loss, and (6) loss causation. *See Dura Pharmas., Inc. v. Broudo*, 544 U.S. 336, 341-42 (2005). Economic loss and loss causation in scheme liability cases generally present no different problems than in misrepresentation cases under Rule 10b-5(b). The reliance and "in connection with" elements of claims under Rule 10b-5 call for brief comment in relation to scheme liability.

A plaintiff may be presumed to have relied on a misrepresentation if the misleading or false information was injected into an efficient market. *See Basic Inc. v. Levinson*, 485 U.S. 224, 247 (1988). The fraud-on-the-market presumption requires the dissemination of the misrepresentation into an efficient market, but not personal involvement by each defendant in disseminating the information. *See AOL Time Warner*, 452 F.3d at 1051; *see also* 4 Alan R. Bromberg & Lewis D. Lowenfels, BROMBERG & LOWENFELS ON SECURITIES FRAUD § 7:469 (2d ed. 2006) (fraud-on-the-market presumption "applies to all

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(Cont'd)
proffered by crafty perpetrators of fraud as a purported cover for their predominantly deceptive conduct in furtherance of the scheme. In accordance with this Court's teaching that Section 10(b) prohibits not only "garden type variet[ies] of fraud," but also "unique form[s] of deception" and "[n]ovel or atypical methods" of committing securities fraud, *Bankers Life*, 404 U.S. at 11 n.7, the standard for scheme liability should look to whether each defendant engaged in conduct that had the principal purpose and effect of creating an artificial appearance of fact about a transaction involving the issuer.

three clauses of Rule 10b-5: (1) scheme to defraud, (2) misrepresentation or omission, and (3) fraudulent course of business"). The Eighth Circuit in this case erroneously held that plaintiffs could not establish reliance because respondents did not make any misstatements to the investing public about Charter. *See In re Charter Communications, Inc. Sec. Litig.*, 443 F.3d 987, 992 (8th Cir. 2006). The court below thus ignored this Court's holding that there need not be a misrepresentation for a defendant to "run afoul of the [Exchange] Act." *Zandford*, 535 U.S. at 820. The Eighth Circuit also failed to recognize that a "device, scheme, or artifice to defraud" or "act, practice, or course of business which operates or would operate as a fraud or deceit on any person" is complete only upon the dissemination to investors of the false appearances created by the scheme or course of business. Thus, reliance in scheme liability cases may be established under the fraud-on-the-market theory.

Similarly, a scheme to misrepresent the financial results or other facts about a company coincides with the purchase or sale of the company's securities because the scheme is incomplete until the fraudulent information generated by the conduct of the participants in the scheme is disclosed to investors. *See AOL Time Warner*, 452 F.3d at 1051. There is no requirement that every participant in the scheme release the information to the public for all defendants in the scheme to have caused the dissemination of false information to the market. *See Central Bank*, 511 U.S. at 191 ("In any complex securities fraud . . . there are likely to be multiple violators."). Indeed, the Eighth Circuit in this case did not deny that plaintiffs adequately pled that defendants' conduct was in connection with purchases or sales of Charter securities. Thus, properly pled scheme liability claims under Rule 10b-5 can satisfy every element of a valid claim.

Private securities litigation is "a most effective weapon" in enforcing the securities laws, serving as a necessary supplement to SEC enforcement actions. *Bateman Eichler, Hill Richards, Inc. v. Berner*, 472 U.S. 299, 310 (1985). Congress, in adopting the PSLRA, reaffirmed that "[p]rivate securities litigation is an indispensable tool with which defrauded investors can recover their losses" and that private lawsuits "promote public and global confidence in our capital markets and help to deter wrongdoing and guarantee that corporate officers, auditors, directors, lawyers and others properly perform their jobs." Conference Report on Securities Litigation Reform, H.R. Rep. No. 369, 104th Cong., 1st Sess. 31 (1995). Investors who are defrauded by sophisticated deceptive schemes such as the sham, round-trip advertising transactions alleged in this case should be permitted to sue all the parties that engaged in deceptive conduct.

II. THE COURT BELOW MISINTERPRETED *CENTRAL BANK*

In this case, as it did in *United States v. O'Hagan*, 92 F.3d 612 (8th Cir. 1996), *rev'd*, 521 U.S 642 (1997), the Eighth Circuit interpreted *Central Bank* far too broadly. Here, the Eighth Circuit construed *Central Bank* to mean that a "device or contrivance is not 'deceptive' within the meaning of § 10(b) absent some misstatement or a failure to disclose by one who has a duty to disclose. . . ." 443 F.3d at 992. This sweeping interpretation of *Central Bank* cannot be squared with either the Court's actual holding in *Central Bank* or the text of Section 10(b) and Rule 10b-5.

In *Central Bank*, this Court addressed a fairly limited question: "whether private civil liability under § 10(b) extends . . . to those *who do not engage* in the manipulative or deceptive practice, but who aid and abet the violation."

511 U.S. at 167 (emphasis added). The plaintiffs in *Central Bank* conceded that the defendant was only an aider and abettor, not a primary violator. *See id.* at 191. Thus, contrary to the Eighth Circuit's overbroad misinterpretation, *Central Bank* did not address whether a device is "deceptive" absent a misstatement or duty to disclose – which is a question regarding the scope of *primary liability* under the statute and rule. Rather, the Court "reach[ed] the uncontroversial conclusion . . . that the text of the 1934 Act does not reach those who aid and abet a § 10(b) violation [and held] that conclusion resolves the case." 511 U.S. at 177.

Moreover, other statements in *Central Bank* demonstrate that the Court did not intend to narrowly proscribe Section 10(b) and Rule 10b-5 such that a "deceptive" device would always require an affirmative misstatement or a violation of a duty to disclose (a reading that is inconsistent with the plain text of the statute and the rule). For instance, after noting that "the text of the statute controls our decision," the Court described the statute as prohibiting all "manipulative or deceptive *acts* in connection with the purchase or sale of securities," *id.* at 173 (emphasis added), a prohibition that encompasses far more than making a material misstatement, refusing to speak when one has a duty to disclose, or engaging in market manipulation. The Court also noted, when explaining why Section 10(b)'s "'directly or indirectly' language" does not justify imposing liability on one who merely aids or abets the violation of another, that "aiding and abetting liability extends beyond persons who engage, even indirectly, in a proscribed activity; aiding and abetting liability reaches persons who do not engage in the proscribed activities at all, but who give a degree of aid to those who do." *Id.* at 176. Thus, *Central Bank* does nothing more than reach the "uncontroversial conclusion" that Section 10(b)

and Rule 10b-5 liability do not attach to actors, including aiders and abettors, unless they *engage, directly or indirectly, in conduct proscribed by the statute and rule.*

The Court's statement in *Central Bank* about the potential primary liability of "secondary actors," including lawyers, accountants, and banks, discussed above, cannot be squared with the Eighth Circuit's constricted reading of that case. *See* 511 U.S. at 191. The mere fact that a party who committed a *primary violation* could *also*, by virtue of the same conduct, be said to have "aided and abetted" another's violation, does not shield the wrongdoer from liability for their own unlawful primary violation. The key question with respect to primary liability remains: Did the secondary actor, who may have aided and abetted another's unlawful conduct, also directly or indirectly engage in the conduct prohibited by Section 10(b) and Rule 10b-5? If yes, the secondary actor can be held liable as a primary violator in a private action.

This unsurprising conclusion finds support in the Court's citation to Daniel R. Fischel, *Secondary Liability Under Section 10(b) of the Securities Exchange Act of 1934*, 69 CAL. L. REV. 80, 107-08 (1981), in *Central Bank*. *See* 511 U.S. at 191. On the specific pages cited by the Court, Professor Fischel stated:

> Deceptive conduct by attorneys and accountants, whether previously analyzed as aiding and abetting or as a direct violation, should continue to be prohibited by the section and the rule, provided the other elements of liability . . . are satisfied.

Id. at 108. Exactly the same conclusion should apply to business counterparties who, like Respondents in this case,

allegedly engaged in "deceptive conduct" that acted as a fraud on purchasers and sellers of Charter Communications stock.

Thus, *Central Bank* establishes three points: (1) the Court in that case was concerned only with deciding whether liability could be imposed on one who did not directly or indirectly engage in the prohibited, deceptive conduct, but simply aided or abetted another party's violation; (2) read as a whole, *Central Bank* establishes that any manipulative or deceptive act in connection with a purchase or sale of securities violates Section 10(b), but that decision does not narrowly confine the acts that fall within the statute's prohibition to require an affirmative misstatement or violation of a duty to disclose; and (3) conduct by a secondary actor that can be characterized as aiding and abetting can also constitute a primary violation of the statute if the secondary actor directly or indirectly uses or employs, in connection with the purchase or sale of any security, any of the deceptive devices and contrivances prohibited by Rule 10b-5.

It was appropriate for the Court in *Central Bank* not to attempt to specifically delineate the distinction between aiding and abetting, on the one hand, and primary liability of secondary actors, on the other. Drawing that distinction would have required the Court to address issues that were not presented by *Central Bank*'s facts. *Central Bank* appropriately left the scope of primary liability of secondary actors to be decided on the basis of pertinent facts.

Moreover, before *Central Bank*, the distinction between aiding and abetting and secondary actors' primary liability did not receive much attention, because a party who aided and abetted a violation of Section 10(b) and Rule 10b-5 could be held liable without regard to whether the defendant also

directly or indirectly engaged in a manipulative or deceptive act or practice. As Professor Fischel observed, "under a strict aiding and abetting analysis, it is irrelevant whether an aider and abettor has engaged in a manipulative or deceptive practice within the meaning of section 10(b)." 69 CAL. L. REV. at 88; *see also In re Parmalat Sec. Litig.*, 376 F. Supp. 2d 472, 495-98 (S.D.N.Y. 2005) (Kaplan, J.). Thus, this Court and the lower courts in earlier, pre-*Central Bank* cases had little occasion to define when secondary actors are primarily liable.

This Court's statements interpreting Section 10(b) and Rule 10b-5 in decisions handed down after *Central Bank*, on the other hand, have particular relevance to the issue in this case, because when it made them, the Court did so knowing both that liability could not be imposed for aiding and abetting and that the outer limits of what constitutes a primary violation of the statute and the rule had yet to be defined. The Court, in all three of its decisions interpreting Section 10(b) and Rule 10b-5 handed down after *Central Bank*, has defined more broadly than did the court below the range of conduct that violates the statute and rule.

In *United States v. O'Hagan*, 521 U.S. 642 (1997), the issues under Section 10(b) and Rule 10b-5 were whether O'Hagan, who had misappropriated material information from his law firm employer and that firm's client, (a) had used a deceptive device and (b) had done so in connection with the purchase and sale of securities. The Court in reversing the Eighth Circuit's decision found that O'Hagan's trading on the basis of misappropriated information, without disclosing that he was doing so, involved the use of a deceptive device, even though O'Hagan did not make any material misstatements and did not owe any duty to speak to the persons with whom he traded. The Court quoted Rule

10b-5(a) and (c) and acknowledged that "[l]iability under Rule 10b-5 . . . does not extend beyond § 10(b)'s prohibition." *Id.* at 651. But the Court also pointed out: "The provision, as written, does not confine its coverage to deception of a purchaser or seller of securities; rather, the statute reaches any deceptive device used 'in connection with the purchase or sale of any security.'" *Id.* (citation omitted).

The Court also observed:

> The misappropriation theory comports with § 10(b)'s language, which requires deception "in connection with the purchase or sale of any security," not deception of an identifiable purchaser or seller. The theory is also well tuned to an animating purpose of the Exchange Act: to insure honest securities markets and thereby promote investor confidence.

Id. at 658 (emphasis added). Finally, the Court faulted the Eighth Circuit for reading too narrowly the statement in *Central Bank* concerning secondary actors' potential liability. It explained that "this Court, in the quoted passage, *sought only to clarify that secondary actors, although not subject to aiding and abetting liability, remain subject to primary liability under § 10(b) and Rule 10b-5 for certain conduct.*" *Id.* at 664 (emphasis added).[7]

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7. Similarly, the Court's statement in *Central Bank* that "As in earlier cases considering conduct prohibited by § 10(b), we again conclude that the statute prohibits only the making of a material misstatement (or omission) or the commission of a manipulative act," 511 U.S. at 177, was not a definitive description of the outer limits of the conduct proscribed by § 10(b) and Rule 10b-5, nor was it

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In *Wharf (Holdings) Ltd. v. United International Holdings, Inc.*, 532 U.S. 588 (2001), a unanimous Court again reaffirmed that Section 10(b) and Rule 10b-5 prohibit a broad range of manipulative and deceptive acts and practices, not simply misrepresentations, omissions, and market manipulation. First, the Court described Rule 10b-5 as follows:

> That Rule forbids the use, 'in connection with the purchase or sale of any security,' of (1) '*any device, scheme or artifice to defraud*'; (2) 'any untrue statement of a material fact'; (3) the omission of 'a material fact necessary in order to make the statements made not misleading'; or (4) *any other 'act, practice or course of business' that 'operates . . . as a fraud or deceit.'*

Id. at 593 (emphasis added). Then, the Court held:

> To succeed in a Rule 10b-5 suit, a plaintiff must show that the defendant used, in connection with the purchase or sale of any security, [any] *one of the four kinds of manipulative or deceptive devices to which the Rule refers*, and must also satisfy certain other requirements not at issue here.

Id. (emphasis added).

Finally, the Court addressed Wharf's policy argument that holding it liable would open the door to "numerous

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(Cont'd)

necessary to the Court's holding in that case. As explained above, *Central Bank* holds that what the statute proscribes can only be determined by reference to the statutory language, which is considerably more inclusive than the foregoing statement, on which *amici* believe Respondents nonetheless are likely to rely.

plaintiffs to bring federal securities claims that are, in reality, no more than ordinary breach-of-contract claims—actions that lie outside the Act's basic objectives." *Id.* at 596. The Court observed that "Wharf has not shown us that its concern has proved serious as a practical matter in the past." *Id.* at 597. It then added: "Nor does Wharf persuade us that it is likely to prove serious in the future," *id.*, and cited in support of this proposition the strict pleading requirements of the PSLRA, including the requirement that a complaint must state facts that support a strong inference that each defendant acted with scienter.

In *SEC v. Zandford*, 535 U.S. 813 (2002), a unanimous Court again held that Section 10(b) and Rule 10b-5 make it unlawful to engage not only in the manipulative and deceptive acts and practices to which the Court alluded in passing in *Central Bank*, but also in other acts and practices that fall within the broadly worded prohibition of the statute and rule. The Court pointed out that "neither the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the Act." *Id.* at 820. Rather, the Court held that Zandford's practice of selling his client's securities and then pocketing the proceeds "was properly viewed as a 'course of business' that operated as a fraud and deceit on [his] customer." *Id.* at 821.

In sum, in all three cases in which the Court has interpreted Section 10(b) since *Central Bank*, the Court has construed the statute to prohibit acts and practices that are outside the Eighth Circuit's overly narrow reading of *Central Bank*. The correct reading of *Central Bank*, as these cases make clear, is that Section 10(b) prohibits the direct or indirect use or employment of all manipulative and deceptive devices and contrivances, including those barred by subsections (a) and (c) of Rule 10b-5.

III. INNOCENT COUNTERPARTIES ARE PROTECTED FROM LIABILITY UNDER SECTION 10(b) BECAUSE THEY DO NOT USE OR EMPLOY MANIPULATIVE OR DECEPTIVE DEVICES AND BECAUSE THEY LACK SCIENTER

Lower courts that have upheld the theory of scheme liability post-*Central Bank* also have developed meaningful distinctions between aiding and abetting and scheme liability. In numerous cases, they have also dismissed some or all of the claims against secondary defendants, which demonstrates that scheme liability can be imposed in a manner consistent with *Central Bank*'s holding that liability cannot be imposed on one who does no more than aid and abet the violation of another.

For example, in *Parmalat*, Judge Kaplan held that two banks which factored and securitized invoices that they knew to be worthless used deceptive devices or contrivances in violation of Section 10(b). 376 F. Supp. 2d at 504. "The transactions in which the defendants engaged were by nature deceptive. They depended on a fiction, namely that the invoices had value." *Id.* By contrast, the same court dismissed claims based on allegations that the banks made loans which Parmalat improperly accounted for as equity investments or assets in its financial statements. *See id.* at 505. "In each of these cases, what remains when the bluster is stripped away are financings and investments. These transactions were not shams. . . . Any deceptiveness resulted from the manner in which Parmalat or its auditors described the transactions on Parmalat's balance sheets and elsewhere." *Id.* Judge Kaplan explained why the scheme liability allegations that he upheld were consistent with *Central Bank*:

> This analysis is not an end run around *Central Bank*. If a defendant has committed no act within

> the scope of Section 10(b) and Rule 10b-5 – as in fact was the case in *Central Bank* – then liability will not arise on the theory that that defendant assisted another in violating the statute and rule. But where, as alleged here, a financial institution enters into deceptive transactions as part of a scheme in violation of Rule 10b-5(a) and (c) that causes foreseeable losses in the securities markets, that institution is subject to private liability under Section 10(b) and Rule 10b-5.

376 F. Supp. 2d at 509-10. A commercial counterparty cannot be liable unless it engages in deceptive conduct with scienter.

Similarly, the Ninth Circuit held in *AOL Time Warner* "that to be liable as a primary violator of § 10(b) for participation in a 'scheme to defraud,' the defendant must have engaged in conduct that had the principal purpose and effect of creating a false appearance of fact in furtherance of the scheme." 452 F.3d at 1048. The court held that this test comports with *Central Bank* because "[t]he focus of the inquiry on the deceptive nature of the defendant's own conduct ensures that only primary violators (that is, only those defendants who use or employ a manipulative or deceptive device) are held liable under the Act." *Id.* at 1049. The Ninth Circuit's test genuinely protects both innocent counterparties and counterparties who engage in legitimate transactions that they know or believe will be misrepresented by others. In *AOL Time Warner*, Homestore.com allegedly agreed to purchase shares in other companies for inflated values or to purchase products or services it did not need, in exchange for the other companies' buying advertising from AOL, which, in turn, paid over much of the revenue to Homestore.com. *In re Homestore.com, Inc. Sec. Litig.*, 252 F. Supp. 2d 1018, 1023 (C.D. Cal. 2003), *rev'd*, 452 F.3d

1040 (9th Cir. 2006). The Ninth Circuit held that under its test for scheme liability, plaintiffs failed to allege valid claims against AOL because it had a legitimate contractual relationship with Homestore.com and did not itself engage in any deceptive acts. *See* 452 F.3d at 1053. The AOL transactions were not mere shams, but rather had economic substance and became deceptive only after Homestore.com accounted for them incorrectly. *See id.*[8]

By contrast, the Enron case illustrates the danger that reading scheme liability out of Section 10(b) and Rule 10b-5 would immunize cunning parties who engage in deceptive conduct with the primary purpose and effect of creating a false appearance about an issuer's financial condition in connection with purchases and sales of securities, but carefully refrain from making direct misrepresentations to investors. *See Regents of the University of California v. Credit Suisse First Boston (USA), Inc.*, 482 F.3d 372 (5th Cir. 2007), *petition for certiorari filed*, No. 06-1341 (U.S. Mar. 5, 2007).[9] In the Enron case, plaintiffs alleged that several firms knowingly engaged in sham transactions with Enron that lacked any economic substance; for example, plaintiffs alleged that Merrill Lynch agreed to "buy" several electricity-generating barges in Nigeria from Enron at the end of Enron's fiscal year to enable it to book revenue and meet analysts' estimates, while at the same time Enron and Merrill Lynch entered into a secret side agreement whereby Enron would buy the barges back the following year at a profit to Merrill Lynch. *See* 482 F.3d at 377.

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8. The court reached the same conclusion as to other companies with which Homestore.com entered into legitimate transactions that Homestore.com then misrepresented in its financial statements.

9. The facts set forth in the petition for certiorari in the Enron case starkly illuminate the stakes of this Court's determination about the scope of scheme liability under Section 10(b) and Rule 10b-5.

Notwithstanding allegations that Merrill Lynch and the other bank defendants deliberately engaged in inherently deceptive conduct to create a false appearance about Enron's revenue and debt levels, the majority of a panel of the Fifth Circuit held that these defendants did not engage in "deceptive" conduct because they had no duty to disclose information to Enron's stockholders. *See id.* at 390.[10] Thus, the Fifth Circuit panel's majority effectively deleted subsections (a) and (c) from Rule 10b-5, leaving only Rule 10b-5(b)'s prohibition of material misrepresentations and omissions. The majority also failed to acknowledge this Court's holdings in *Zandford* that "conduct, without more" can constitute a deceptive device or contrivance under Section 10(b) and Rule 10b-5 and that "neither the SEC nor this Court has ever held that there must be a misrepresentation about the value of a particular security in order to run afoul of the Act." 535 U.S. at 820-21. At the same time, the majority recognized that "the court's interpretation of § 10(b) could have gone in a different direction and might have established liability for the actions the banks are alleged to have undertaken," and that its decision "may not coincide . . . with notions of justice and fair play." 482 F.3d at 393. In the view of *amici*, the Fifth Circuit majority's decision cannot be

10. Judge Dennis of the Fifth Circuit concurred in the judgment reversing class certification, on the ground that the district court misinterpreted the PSLRA's joint and several liability provision and should reconsider whether common damages issues would predominate over individual issues under the correct standard. *See* 482 F.3d at 395 (Dennis, J., concurring in judgment). However, Judge Dennis identified the errors of the panel majority's "cramped interpretation of the statutory language of section 10(b)" and criticized the majority for "immuniz[ing] a broad array of undeniably fraudulent conduct from civil liability under Section 10(b), effectively giving secondary actors license to scheme with impunity." *Id.* at 394.

squared with the language of Section 10(b). Like the decision below, it reflects an overbroad reading of *Central Bank*.

This Court has given weight to the policy concern that securities litigation against secondary actors poses the risk of coercive settlements divorced from the merits of the cases. *See Central Bank*, 511 U.S. at 189. That concern, and more importantly the text of Section 10(b) and Rule 10b-5, justified *Central Bank*'s rejection of aiding and abetting liability. That concern should not and cannot justify negating the plain language of the statute and rule to eliminate primary liability of secondary actors who themselves knowingly engage in deceptive conduct in connection with purchases and sales of securities, especially because the requirement that the defendant itself have engaged in deceptive conduct, with scienter, will prevent non-meritorious claims.

CONCLUSION

The judgment of the court of appeals should be reversed.

Respectfully submitted,

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